EMERALD

EMERALD ADVISERS, INC.
2010 1ST QUARTER ECONOMIC & PORTFOLIO COMMENTARY

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ECONOMIC REBOUND TAKES HOLD

	1st Quarter 2010
Russell 2000 Growth	7.61%
Russell 2000 Value	10.02%
S&P 500	5.39%

So goes January, so goes the year? We don't think so. After a tumultuous start to the quarter and the year with January index returns in negative territory, absolute market returns improved in February and March. The economy continues to recover, and concerns over Greece and the debt of other sovereign nations, while not out of the headlines, are not causing the same level of volatility witnessed earlier in the year. The volatility index remains low and while risks still remain it appears as if the market believes that ultimately the European Union and/or the International Monetary Fund will rescue Greece, limiting the systemic risk. A situation, however, we continue to monitor. Domestically, there has certainly been some encouraging news. Consumer spending rose in February for the fifth consecutive month, jumping 3.4% from a year earlier, and the number for March may be even better. The consumer's balance sheet is improving. Household net worth rose 11.8% to $54 trillion in the fourth quarter from $48.5 trillion in the first quarter of 2009. Debt is down, as are delinquencies. As a result, spending is increasing and savings are declining. The savings rate in February fell to 3.1%, its lowest level in more than a year. Given the historical correlation between consumption and jobs/income growth, we have to question whether the consumption trends witnessed year-to-date are foretelling an improving job market. Emerald believes it may be based on the feedback we are getting regarding hiring intentions at the company level. Admittedly, this feedback has yet to translate to the magnitude of employment growth we believe possible, as evidenced by the disappointing March report. But it appears that the economy is certainly headed in the right direction. Temporary staffing increased for the sixth consecutive month, the average work week lengthened further and permanent private sector employment jobs were added.

Manufacturing has continued its rebound as evidenced by March's very strong ISM figure and earnings growth has continued to surprise to the upside. First quarter earnings results were better than expected and as we move into the second quarter Emerald is expecting more of the same. According to Furey Research, the median Russell 2000 stock is expected to post 5% revenue growth and 36% earnings growth in 2010. At the sector level, earnings growth remains tilted toward the more cyclical sectors with materials, technology, energy, industrials and consumer discretionary driving the greatest bottom line growth. Small cap earnings are expected to continue to outpace that of their larger capitalization brethren. According to Furey Research, relative to the S&P 500, the median Russell 2000 stock is expected to post 13% better 2010 earnings growth than the median S&P500 stock.

Corporate cash hoards are growing rapidly as earnings accelerate. As a result, stock buybacks are accelerating and Emerald believes merger and acquisition activity will likely accelerate as well. Private equity, after being dormant on the merger and activity front for the better part of the last two years, has moved into the market with a handful of deals announced over the last few weeks and the initial public offering market is heating up, especially in the area of technology.

The risks, however, remain abundant and the list long: pace and durability of the recovery, sustainability of consumption, rising energy prices, ultimate withdrawal of stimulus, the federal deficit, tax hikes, healthcare reform costs, regulatory climate, Greece and other sovereign nations on the watch list, the possibility of another surge in foreclosures, Chinese trade relations and other matters of foreign policy/geopolitical concerns, not to mention inflation concerns which continue to periodically rear their head, to just name a few. Without question, there are many possibilities in this list that could derail/temper Emerald's optimistic outlook, but at this point and based on the facts and observations made to date, we continue to maintain that domestic economic growth is more likely to surprise to the upside as the year progresses. This should provide a solid tailwind for revenue and earnings growth, and ultimately stock prices.

Portfolio Performance

Performance has trailed the benchmark on a year-to-date basis as a result of stock selection within consumer discretionary and materials, as well as the relative weakness of the technology sector, to which the portfolio remains overweighted. While the portfolio outperformed in both the energy and financial services sectors, these gains were unable to offset the aforementioned.

At the sector level, underperformance of the technology sector relative to the benchmark's aggregate return proved to be a headwind to portfolio performance as a result of the portfolio's relative overweight position. While we have substantially reduced the relative overweight position over the last few months, Emerald remains comfortable with portfolio's overweight position to the technology sector, despite the sector's underperformance during the first quarter. Earnings growth within the sector on a relative basis is projected to remain strong, as discussed above, through the balance of the year. Further, while the cyclical aspects of technology are certainly appealing we believe there are several secular trends including: the transition to light emitting diodes (LED), growth in wireless networking, intelligent networking, on-demand software and cloud computing that will likely equate to elevated levels of growth relative to the sector overall. From a top down demand perspective, the fourth quarter advanced GDP figure was better than expected at 5.6%. Within that figure, and most relevant to Emerald's comfort with our technology outlook, was the significant acceleration in software and equipment expenditures, which grew more than 13%. The growth in software and equipment expenditures as reported in gross domestic product is representative of the acceleration Emerald has witnessed in the earnings results of many of the portfolio's technology holdings. Comments from Cisco further reinforced our observations. During the company's early February conference call John Chambers CEO of Cisco stated that "In our opinion based upon our business momentum in prior economic recoveries, this would indicate that the recovery from a capital spending perspective is very strong and moving into the second phase of reasonably balanced across-the-board growth." While Cisco is certainly not a small cap company, Emerald believes that Chambers' commentary is representative of what many of our small capitalization technology companies are seeing as well. Emerald remains optimistic regarding the outlook for the technology sector.

The consumer continues to astound, as does performance within the consumer discretionary sector which was the strongest performing sector on an absolute return basis within both the portfolio and the index for the quarter. Emerald has continued to add exposure to this sector, which now represents the portfolio's largest relative overweight position. While Emerald performed essentially in-line with the benchmark, the portfolio achieved notable performance with diversified retail, specialty retail, and textiles and apparel. These industries represent the largest industry overweight positions within the consumer discretionary sector. Traffic trends have stabilized, inventory levels remain lean, corporate expenses have been reduced, rents and real estate prices have declined but are now stable and as a result the management teams with which we converse are again embarking on growth initiatives. There remains however a high degree of cynicism regarding the sustainability of these improvements. We maintain a healthy level of cynicism ourselves. But the improvement in retail sales experienced over the last five months in the face of what has been called a "jobless recovery" cannot be denied. No doubt there is a certain element of pent-up demand and tax refunds are likely a contributing factor. Given that spending is most correlated with employment and income, one certainly has to question whether consumption trends are a leading indicator to jobs and income growth. Only time will tell. In the interim the portfolio remains focused on the fastest growing companies with niche opportunities on which they are poised to capitalize.

The portfolio also remains overweight the materials sector, which underperformed in the quarter. The balance of the holdings are diversified among building materials, chemicals, packaging and metals, each of which is poised to benefit as the economy continues on its recovery path. The March ISM figures were favorable and we believe supportive of the overweight position.

Emerald's favorable financial sector performance benefitted from our overweight position in banks. We believe that we are close to a peak in non-performing loans, and that the next catalyst for high performing banks is a decrease in non-performers in the second half of the year. We continue to favor those banks that have raised capital to very high levels, have mostly repaid TARP, and have turned their attention towards the many growth opportunities that have availed themselves to the market due to the current market turmoil. While Emerald remains favorably inclined toward the banking industry, the portfolio remains underweight the financial services sector.

The balance of the portfolio is comprised of underweight positions in healthcare and producer durables. Healthcare performance has continued to be challenged by concerns regarding healthcare reform and growth remains more attractive in other sectors. While the producer durables sector remains underweight, Emerald has continued to add to the position, most recently adding exposure to the aerospace and shipping industries. Emerald continues to look for additional opportunities within this sector.

Although disappointed with performance year-to-date, Emerald believes the portfolio is positioned for growth. While value stocks have dominated performance so far this year due more to the distribution of the sector returns, we believe that earnings growth will be most pronounced in the more cyclical sectors of the economy. Therefore, believing as we do that earnings growth drives stock prices this trend should bode well for the Russell 2000 Growth benchmark and the portfolio as we move through the balance of 2010.

Outlook

Springtime in the northeast brings "green shoots" of a more recurring nature than those so often talked about by market pundits. As we have discussed, there is ample evidence that the recovery that began late last year is transitioning from an economic rebound into a self-sustaining economic expansion. Our optimism is framed by cash-rich corporate balance sheets and lean operating structures, but tempered by our experiences that business cycles rarely go back to trend line smoothly. However, with over $1 trillion of cash in corporate coffers, the highest level since 1955, we think spending on both productivity enhancing equipment and on market expanding acquisitions may become quite prevalent as 2010 unfolds.

The market and its participants continue to argue about the shape, velocity and duration of the present expansion. We have the "New normal" versus vigorous recovery camps. We have double-dippers versus "v" shapers. And behind them all, we have an investing public not yet ready to engage, sitting on the sidelines unenthusiastic about committing capital but preoccupied by the microscopic yield on their money market balances. Which camp does Emerald subscribe to? We would probably say that this recovery has been more "normal" than many want to give it credit for, even though the markets want to cling to it being "different this time." Ultimately, what helped the U.S. recovery the most was speed: speed of the policy response and speed of the private sector response in relation to cost cuts and restructuring and in searches for efficiency and productivity. The obvious casualty has been payrolls, which have been stubborn to show dramatic improvement. Consensus expectations are for another jobless recovery on the way. However, leading indicators such as temporary staffing gains, a decline in layoffs and improvement in the ISM data, all point to a continued thaw for the labor markets. Recognizing that sustaining consumer confidence will rely on a more vigorous job recovery, we tend to agree with economists such as Michael Darda of MKM Partners who predict growth in labor in the very near months ahead. With jobs comes incomes and improving psychology; with incomes comes growth.

In our view, the risk in the economy is still to the upside. Lean cost structures afford dramatic margin expansion as incremental revenue comes in. An historically steep yield curve is unambiguous about growth. Earnings surprise and positive revisions will continue to drive stock prices, but should now be anchored by revenue growth versus cost cutting. The newspaper headlines have been overwhelmed by talk of "sudden acceleration." Given the maturation of our economic rebound, we would expect those headlines to migrate to the business page. Sudden acceleration is something you actually *want* to see in the world of investing, and something we *expect* to see as growth stock investors going forward. We are cognizant of, but not dissuaded by, the headwinds of rising oil, increasing input costs and changing tax policies. We will of course watch these variables closely and monitor our companies' responses for clues about the eventual amplitude and duration of growth in this unfolding expansion. The "Great Recession" has indeed ended, but the after-effects of the financial crisis are likely to be apparent throughout the recovery. As is typical in the first phase of recovery, ample capacity and lack of wage growth is likely to put downward pressure on near term inflation numbers, but expectations here will be a key driver of Fed policy going forward.

There is no shortage of things to worry about as far as the "top-down" prognosticators are concerned; but from a bottom-up micro-sense, we are very enthusiastic about the opportunities that we see in the small cap universe. We continue to be committed to our belief that improving revenue, margins and earnings drive stock prices. From here, individual company fundamentals should matter again. From here, superior business models should again demand premium valuations. And from here, active, research-based stock investors should again begin to outperform. Thank you for all of your time and consideration.

- *April 9, 2010*